

A NOTE ON IS-LAM STABILITY AND ECONOMIC POLICY

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I

IN his classic article "Liquidity Preference and the Theory of Interest and Money," Professor Modigliani (1951, p. 208) argues that

If [a] system is stable, each variable approaches some definite value which it will maintain in time until there occurs some change in the form of [a] functional relationship or in some parameter...

working within the context of a simple two-market (commodity and money) model it is then argued by Modigliani (1951, p. 209) that

Stability requires that the slope of the IS curve be algebraically smaller than the slope of the LL curve.

This stability condition has come to be accepted in the literature and has even become common place in the textbooks.

What is not generally recognized is the fact that this stability condition pertains merely to two-equation, IS-LM economic systems in which the combined interest sensitivity of consumption *plus* that of investment is non-positive. Two recent studies, however, cast doubt upon the argument that this combined interest sensitivity is non-positive. Weber has found that, on balance, consumption spending is *directly* related to the interest rate :

When the rate of interest increases, consumers have the opportunity to maintain the same level of consumption in the future with less saving today. Consequently, they increase current consumption in response to the interest rate increase (1970, p. 600).

This is similar conceptually to what Musgrave (1959, pp. 264-265) has referred to as the "target saver." In turn, Yarrow (1975, p. 582) maintains that

... the growth rate of the firm, and hence its level of investment, may be an *increasing* function of the rate of interest...

Yarrow argues that such behaviour is a characteristic of the growth-maximizing firm.

The purpose of this Note is to ascertain whether the Modigliani stability condition is relevant for systems where the combined sensi-